No. 13, 039

IN THE

United States Court of Appeals

For the Ninth Circuit

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a National Banking Association, and EUGENE J. O'RILEY, as Trustee, in Bankruptcy of the Estate of UNITED PRODUCE COMPANY, a corporation, Bankrupt,

Appellants,

vs.

MERCHANDISE NATIONAL BANK OF CHICAGO, a National Banking Association,

Appellee.

Appellee's Supplemental Memorandum Commenting on Appellant's Reply Brief

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No. 13,039

IN THE

United States Court of Appeals

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BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a National Banking Association, and EUGENE J. O'RILEY, as Trustee, in Bankruptcy of the Estate of UNITED PRODUCE COMPANY, a corporation, Bankrupt,

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The essence of defendant's reply brief is that it ignores *this case.* For example:

1. The Findings.

The findings are never mentioned.

2. Identity of Lofendo and the Fact of Fraud.

Defendant ignores the fact that "Lofendo" and United Produce Company were identical, and that because of the fraud "United Produce-Lofendo" never acquired any rights against plaintiff.

3. Ownership of the Checks.

Defendant ignores the fact that it never became the owner of the checks, having taken them only as agent for collection.

It ignores the fact that the use of a collection letter instead of a cash letter informed plaintiff that defendant was not the owner, and that the transaction between plaintiff and defendant did not proceed on the assumption that defendant was.

4. Plaintiff Not Defendant's Agent.

Defendant ignores the fact that under the Massachusetts rule, which governs this case, plaintiff was not defendant's agent and owed no duty to it. Plaintiff's duty lay to "Lofendo," and because "Lofendo-United" was a defrauder, there was no duty at all.

For example, defendant cites a case which it states it had not found before, *Commercial National Bank v. Armstrong,* 148 U.S. 50. There the New York rule governed, and the collecting bank was the agent of the forwarding bank. Its duties were therefore to the forwarding bank and not to the latter's customer, as here. The court emphasized the particular contractual arrangement there proved as existing between the two banks whereunder the collecting bank was permitted to mingle collected funds with its own and to assume a debtor instead of an agent relationship to the forwarding bank (p. 58). In turn the collecting bank was the principal of other banks which were its agents.

5. The Contractual Arrangement Proved and Found.

Defendant ignores the contractual arrangement *proved in this case.* To escape the fact that the cases relied on by it are cash letter cases, it says (p. 37) that none of them remarked that a cash letter was used but merely showed that credit had been initially given by the forwarding bank to its customer. But when we labeled the cases as "cash letter cases" we did so as a shorthand way of describing them as cases in which initial credit had

been given, from which other consequences followed. Because a forwarding bank has given credit, it either has become the owner of the paper, or it so appears to all successive banks in the collection chain, and the banks treat with each other upon that assumption (see our brief, p. 91). In a collection letter case the forwarding bank has not become the owner, and the form of document used so informs all other banks. Necessarily the contractual arrangement between the forwarding and collecting banks is different.

Defendant argues (R. Br. 15) that the advices of credit were not necessary parts of the transactions but only evidence. There *can* be contractual arrangements where that is true. Cash letter cases are examples. But a collection letter case is not. The nature of the contractual arrangement is one of fact. The findings in this case are against the defendant.

We have shown that the findings as to the meaning of the collection contract are supported by the practical construction of the parties (Our brief, p. 83). Defendant addresses itself to but part of the facts. It argues that what the parties did on November 17th and 18th was not a construction of the contract (R. Br. 34) because the parties did not mention "contract".

But, obviously, the parties were construing their rights and duties under the collection arrangement. When defendant's head office wrote its branch that it must obey the plaintiff's instructions, it construed its duties to the plaintiff and to its customer Lofendo. The collection arrangement was a contract, and so the parties were giving a practical construction of that contract.

6. Payment a Secondary Question.

Defendant assumes that the question in the case is whether the checks were "paid", ignoring the different senses in which the term "payment" is used and the fact that payment or non-payment is a preliminary question. Bank collections may give rise to

various problems as between various parties, and what may be payment for one purpose is not for another.

The artificiality of the argument that the checks were paid is shown by defendant's statement (R. Br. 46) that when the payment was made the agency ceased and "Merchandise became indebted to Bank of America in the amount of the checks." If paid, plaintiff would not still be obligated to anyone upon them. Obviously what defendant really means is not that the plaintiff paid the checks by what happened in Chicago but that it became obligated to pay them.

But this is tantamount to saying that plaintiff "accepted" the checks and answers defendant's argument under Section 207(a) of the Illinois Negotiable Instruments Law.

Our brief showed that Section 207(a) gives defendant no support, because failure to reject within the described time at most would only be equivalent to acceptance, not payment, and left plaintiff with all defenses appropriate when acceptance has resulted from fraud.*

Defendant asserts that if retention is equivalent to acceptance and not payment, "no one would be more astonished than the bankers of this country" (R. Br. 5). On the contrary such statutes are referred to as establishing an "acceptance by retention rule".

A simple consideration suffices to show that retention beyond a described period is at best "acceptance" and not "payment". The statute applies equally whether the check comes through the mail directly from the payee or from a forwarding bank. Had the checks come by mail from "Lofendo" it would be absurd to say that he was "paid" by the retention, for he got nothing. So also, the statute applies equally whether the collecting bank has a deposit account with the forwarding bank or not. So here, if plaintiff had had no deposit account with defendant, the only

*Defendant counters that a check does not operate as an assignment from maker to payee. True, but the assignment results from the check plus the acceptance by retention.

way the latter could assert any rights against plaintiff on the basis of the retention would be to sue, i.e., to allege that plaintiff had become obligated to pay. But "obligation to pay" is "acceptance" and is subject to being defeated by fraud, mistake or other equities.

7. There Were No Proceeds of the Checks.

Repeatedly defendant's arguments rest on the assumption that there were "proceeds" of the 6 and 4 checks (e.g., Br. 15, 24, 26, 28), citing cases where a collecting bank had actually collected money from another (see our brief, p. 98).

But here no funds were collected. There were no "proceeds". United Produce had no funds in its account, and it (i.e., Lofendo) could not have compelled plaintiff to honor the checks.

For example, to avoid the effect of our demonstration that plaintiff could have become liable to it only on the basis of a contract between them requiring consideration (Our brief 56), defendant argues that plaintiff became liable to it because plaintiff obtained "proceeds" (pp. 24, 29). This savors of a money had and received theory. But plaintiff obtained no proceeds. And even if it had, they were not proceeds which belonged to the defendant, for the defendant was not the owner of the checks.

8. Defendant Has Only Such Rights as It Derived from Lofendo, Who Had None.

Since Lofendo had no rights against plaintiff, defendant is compelled to deny that it derived whatever rights it has through him (R. Br. 67). But analysis of its arguments shows that they all rest on Lofendo's rights.

Basically defendant rests on an odd assertion that it became a "bona fide purchaser of a right of set-off" (e.g., R. Br. 41-46).

The assertion must be analyzed to be understood. To be a bona fide purchaser one must at least buy something from another. Who owned a right of set-off which defendant bought? Obviously no one. And when defendant says that it became a bona fide pur-

chaser, does it mean that it paid out money or incurred any liability to anyone in reliance on an assumed liability of plaintiff to it? Obviously, no. The findings are otherwise and are not assailed.

And what is being set off against what? Defendant says (R. Br. 42) that when a depositor becomes indebted to a bank, the bank "acquires the right to offset such indebtedness of its depositor against any credits to which he is entitled." Does this mean any credits the depositor has against the world? Obviously not.

What defendant does seem to mean is that it had a right to set off against any sums it owed Lofendo any sums he owed to it. Now (1) this has nothing to do with bona fide purchase of anything, and (2) in order to become pertinent to plaintiff, defendant must somehow involve plaintiff in a liability of its own to Lofendo. In other words, defendant assumes, not only that it had a liability to Lofendo, but that such liability was a correlative of a liability of plaintiff to defendant. This it reveals when it says (R. Br. 42, 49) that "Lofendo became entitled to credits". What credits? Defendant means such credits as Lofendo had, based on the 6 checks and the 4 checks. But Lofendo had no rights because he was United Produce, and United Produce had no rights arising out of the 6 checks or the 4 checks because of its fraud.

At the base of all defendant's arguments lies this assumption, that it became absolutely liable to Lofendo on the 4 and 6 checks the moment plaintiff made entry on its internal books in Chicago. In short, defendant rests its case on "Lofendo's" rights, as necessarily it must do, since "Lofendo" was the payee.

This is again demonstrated by an argument (R. Br. 30) where it tries to avoid the effect of its practice of not charging plaintiff's account until receipt of an advice of credit and subsequent instructions from the branch. It argues that if Lofendo had asked for credit after an advice of credit had been received, it could not have declined to advise the head office to charge plaintiff's account.

But Lofendo's only right would be to recover such damages as he suffered by defendant's failure to complete the duties it assumed as agent under the collection contract. But since Lofendo and United Produce were one and were defrauding plaintiff, Lofendo would suffer no loss by reason of defendant's refusing to charge plaintiff and credit him.

Contrast this argument with what defendant states elsewhere in its brief, e.g., pp. 34, 68. There it argues that when it agreed with plaintiff on November 17th and 18th not to enter credit to Lofendo, it did so only in the belief that it, the Bank of America, was in the clear. But this is a frank avowal that defendant recognized then and recognizes now no duties or obligations to Lofendo. Had it such a duty, it would be irrelevant whether it was in the clear or not.

Thus in one breath it rests its rights against plaintiff upon its duties to Lofendo. In the next it asserts that it had no duties to him. Of course it had none to him, in view of his fraud upon the plaintiff. Had he seen fit to sue defendant, it could have interpleaded plaintiff here.*

A bank may offset what it owes a depositor against what he owes it. Doubtless this offset may be claimed against anyone who derives his rights to the credits *from and under* the depositor. But no automatic offset exists to cut off someone whose rights are not derived from or under the depositor but are *superior* to him, as here. *Weiner v. Roof,* 19 Cal.2d 748 (our brief, pp. 55 and 75).

In an effort to avoid the principles stated in *Weiner v. Roof* (our brief, p. 65, et seq.), defendant asserts that that case applies to payments to an agent, and that when plaintiff "paid" the

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*At the trial defendant's Branch Manager admitted that "Mr. Lofendo's rights and [the defendant's] duty to Lofendo did not pop into [its] head until [it] had decided to protect [its] own loss by taking the $113,000." (R. 422) And it was testified that so long as defendant believed that the account was in the black it had no concern for alleged rights of Lofendo (R. 420-423), and its counsel advised—correctly—on November 18th that Lofendo had no rights in the premises (R. 421).

checks defendant ceased to be Lofendo's agent and became his debtor (R. Br. 48). Assuming that the checks were "paid," whatever the contract was between Lofendo and defendant whereby it could change its position from agent for him to debtor to him, the fact is that the plaintiff "paid" to defendant as *an agent of Lofendo.* The checks had come to the plaintiff through a "collection letter" which informed it that the defendant was not handling the checks for a depositor in a debtor-creditor relationship but as a special situation on an agency basis. If, as between themselves, Lofendo and defendant could change their relationship no such change could cut off plaintiff's rights. They could be cut off only by actual application before notice (see our brief, p. 74).

9. Quarrel with the Findings.

Defendant then (p. 49) resumes its quarrel with the findings as to the time of application of the $89,813.10, although it never mentions the findings.

The critical question is: When did defendant take plaintiff's funds, i.e., when did it charge the $89,813.10 *against plaintiff's account?* That charge occurred November 19th, predated to the 18th (see our brief, p. 20) and defendant had no right to make that charge after notice of the fraud, which it already had.

Defendant never mentions this charge at all. Instead it speaks of the time of *crediting* a like sum *to the Lofendo account.* But that could be pertinent only if there was an estoppel, i.e., only if defendant had paid out money in reliance on the credit and before notice. But that it never did.

In any event, the crediting of the sum to the Lofendo account occurred after notice. Defendant refers to a stipulation which states several things on this subject, i.e., that the $89,813.10 was "put in the counter work" on November 17th (R. 1181) and that the credit was entered on November 18th (R. 1183). These two

statements are reconciled under the stipulation at R. 861, that the practice was to predate an entry by one day.

Undeniably, the credit had not yet been made when Mr. LeRoy talked to defendant's officers on November 18th (R. 452-455). And Messenger's telephone call had already put defendant on notice on November 17th. The evidence is ample to support the finding. Defendant admits that its branch manager, Estribou, did make a statement on November 18th showing that no such credit had yet been made, but it argues (R. Br. 50) that "doubtless" he had before him the ledger sheet before posting although the credit had been entered. The word "doubtless" shows speculation, and findings cannot be upset by speculation.

Defendant also comments on the time when the charge of $75,586.86 was "put in the counter work" against the Lofendo account (Br. 50). This is irrelevant, because on November 16th defendant was already bound in this sum by reason of charges and credits entered *in the clearing house*. And no reliance on the advice of credit for the $89,813.10 had anything to do with it.

10. Defendant Maintained No Deposit Account with Plaintiff.

Defendant's arguments ignore the fact that plaintiff had a deposit account with it but it had none with plaintiff.

Defendant discusses Section 16(c) of the California Bank Act at length (Br. pp. 17-22). This section relates only to cash letter transactions, for it relates to a situation where the forwarding bank has given a credit to its customer. That was not the situation here.*

*While we referred to this section in our own brief we did so merely as corroborating the contractual arrangement between Lofendo and the defendant as demonstrated by the documents under which his account was maintained. His rights could be no greater under a collection letter where he was given no credit than they would have been under a cash letter transaction where he would have been given a credit.

Defendant labors the question whether, when the section speaks of a "credit * * * with any bank designated as a depositary by the bank allowing such credit," it refers to designation by the forwarding bank (here defendant) or by the collecting bank (here plaintiff).

That question is irrelevant.* The book entry on which defendant relies is merely the notation on the internal records of plaintiff. But plaintiff *was not defendant's depositary,* because defendant had no deposit account with plaintiff.† That is an admitted fact. Plaintiff had not been designated as defendant's depositary by anyone (see our brief, p. 59).

This fact also disposes of the argument about *reciprocal accounts* (cf. R. Br. 38, 39). Banks sometimes maintain deposit accounts with each other, so that either may draw checks on the other. No such case here exists. Here the only deposit was that maintained by the plaintiff with defendant.

Defendant argues (Br. 24) that under *Luckehe v. First National Bank,* 193 Cal. 184, if it had accepted "in payment" of the checks something it was not authorized to accept, it would still have become liable to Lofendo. There are two obvious answers: (a) The purpose of Section 16(c) was to make clear that a forwarding bank does *not* become liable to its depositor until whatever it accepts ripens into cash in hand unless what it has accepted is one of the modes of payment authorized by the act. And a credit on plaintiff's books was not one of them. (b) Even before

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*We think the Act meant designation by the collecting bank. Prior to 1943 the words "forwarding bank" appeared instead of the words "bank allowing such credit." This was changed by amendment in 1943. Unless there had been a legislative intention to change the meaning, the amendment merely substituted ambiguity for clarity.

†Defendant argues (R. 33) that plaintiff's records in Chicago of its relationship with defendant was not internal because the ledger cards were similar to those kept by defendant in San Francisco. The essential difference is that plaintiff had a deposit with defendant, not vice-versa, and that while the defendant sent copies of its ledger to plaintiff monthly, plaintiff sent no copies of its records to the defendant (see our brief, pp. 85, 86).

Section 16(c) a bank accepting something other than cash did not become liable for the amount of the check as such, but only for such loss as it imposed on its principal by surrendering the check, e.g., by accepting a draft upon a bank becoming insolvent. But here Lofendo would have had no action against defendant, because he was the United Produce, and United Produce suffered no legal loss because it had no legal rights to obtain anything whatever upon the checks drawn on plaintiff.

11. Abandonment of Counterclaims for Negligence and Absence of Issue of Participation in Conspiracy.

Defendant's reply brief does not assert any right to recover against the plaintiff on its counterclaim for negligence (see reply brief, p. 55). It now restricts its position by saying that it raises the issue of negligence only as a defense against the plaintiff's right to recover "payment" for mistake or fraud. It hastens to admit that negligence is no bar to a right of a payor to recover on those grounds. But it asserts that negligence plus prejudice to the other party is a bar (R. Br. 53). But the kind of prejudice required by the law is prejudice resulting from change of position by the recipient *in reliance on the payment* (see our brief, pp. 66, 70, 71).

And defendant never changed its position in reliance on the alleged payment. It is so found (see our brief, p. 30). And defendant's brief does not claim that it did. What it claims as prejudice is not reliance on the alleged payment but damage from plaintiff's alleged negligence. This, however, brings it back to its counterclaim for damages, completely answered in our brief and not touched upon in reply.

In short, defendant's argument simply short-circuits two different ideas.

Defendant urges (R. Br. 57) that the trial court erred in failing to find on an issue whether plaintiff participated in United's fraud, i.e., was a co-conspirator with United in its swindle. *There was no such issue in the case* (see our brief, pp. 107, 108).

Defendant proposed findings which it requested the trial court to make, and they were printed in the record at its request (R. 119-164). It will be seen that it never requested a finding that plaintiff participated in United's fraud. All that it asked was for a finding of negligence (See R. 126-142). Then, after the appeal was taken, it filed in this Court a 27-page "Statement of Points on Which Appellant Intends to Rely on Appeal". Therein it not only did not mention any claim that plaintiff participated in the fraud, but it affirmatively said (p. 26, line 1): "Neither plaintiff nor defendant were participating in United's fraud and they were both innocent of that fraud". And, finally, there is no specification of error on this subject in any of the 15 specifications in defendant's opening brief (pp. 11-14).*

CONCLUSION

It is respectfully submitted that the judgment is correct and should be affirmed.

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*Defendant's specification of error No. 9 (O. Br. 12) asserts that the trial court erred in not finding with respect to the issue "whether Merchandise either knew of the kite or was guilty of negligence in not discovering it." This merely pertains to negligence. Knowledge of a kite would not be knowledge of a fraud, and even knowledge of a fraud would not be equivalent to participation in a conspiracy to defraud. *United States v. Potash,* 118 F.2d 54 (2 Cir.), cer. den. 313 U.S. 584; *Truck Drivers Local No. 421 v. United States,* 128 F.2d 227, 235 (8 Cir.); *Estep v. United States,* 140 F.2d 40 (10 Cir.); *United States v. Gerle,* 125 F.2d 243 (3 Cir.).